VZCZCXRO4414
RR RUEHDE
DE RUEHCV #2244/01 2091834
ZNR UUUUU ZZH
R 281834Z JUL 06
FM AMEMBASSY CARACAS
TO RUEHC/SECSTATE WASHDC 5646
INFO RUEHHH/OPEC COLLECTIVE
RUEHAC/AMEMBASSY ASUNCION 0670
RUEHBO/AMEMBASSY BOGOTA 6825
RUEHBR/AMEMBASSY BRASILIA 5658
RUEHBU/AMEMBASSY BUENOS AIRES 1353
RUEHLP/AMEMBASSY LA PAZ 2215
RUEHPE/AMEMBASSY LIMA 0462
RUEHSP/AMEMBASSY PORT OF SPAIN 3212
RUEHQT/AMEMBASSY QUITO 2299
RUEHSG/AMEMBASSY SANTIAGO 3659
RUEHDG/AMEMBASSY SANTO DOMINGO 0277
RHEHAAA/WHITEHOUSE WASHDC
RHEBAAA/DEPT OF ENERGY
RUCNDT/USMISSION USUN NEW YORK 0396
RUCPDOC/DEPT OF COMMERCE
RUEATRS/DEPT OF TREASURY
RHEHNSC/NSC WASHDC

UNCLAS SECTION 01 OF 06 CARACAS 002244

SIPDIS

SIPDIS

NSC FOR DTOMLINSON

E.O. 12958: N/A
TAGS: ECON VE
SUBJECT: "TAN BARATO, DAME DOS" (SO CHEAP, GIVE ME TWO):
CONSPICUOUS CONSUMPTION UNDERMINES VENEZUELA'S FUTURE
ECONOMIC WELLBEING

This message is sensitive but unclassified. Please treat accordingly.

¶1. (U) SUMMARY: Record high petroleum prices have handed Venezuela strong economic growth and a sharp increase in national income. BRV fiscal and economic policies are incentivizing Venezuelans to direct this newfound wealth toward credit-financed consumption, in general, and consumption of imports, in particular, rather than toward saving and investment. In the near term the steady flow of petrodollars will moderate the negative effects of these distortions in Venezuela's economy. But failure to invest in and diversify Venezuela's non-oil-export and import-competing sectors will leave the country overly reliant on its oil sector for income, with painful consequences for ordinary Venezuelans. END SUMMARY.

-- ----------
VENEZUELAN CONSUMPTION, SAVING, INVESTMENT, AND IMPORTS
-- ----------

¶2. (U) Venezuela's economy is growing briskly. With petroleum prices at record levels and the Venezuelan oil basket currently selling at USD 64.83, Venezuela's real GDP grew 10 percent year-on-year through the first quarter of ¶2006. (NOTE: Broadly speaking, the BRV and the Venezuelan private sector can either consume or save the income derived from this growth in output. In macroeconomic terms, consumption, by either the public or the private sector, is current expenditure on goods and services. Saving is simply income not consumed. Saving is in turn intermediated through the banking and financial sectors -- which transform savers' cash into loans and other credit for borrowers -- and thus becomes the domestic source of funding for investment. Investment is public- or private-sector expenditure intended to enhance future economic output, e.g., on infrastructure, plant and equipment, or inventories. In short, the more of its income a country consumes, the less it saves and invests.

END NOTE.)

¶3. (U) According to a recent analysis by MetroEconomica, a leading Venezuelan macroeconomic consulting firm, comparing the twelve months ending March 2006 with the twelve months ending March 2005, in constant 1997 prices (i.e., adjusted for inflation), overall Venezuelan consumption grew by 17.4 percent. Perhaps more important, much of this consumption is of foreign goods: imports to Venezuela increased by 22.6 percent in real terms, while exports increased by 4.4 percent over the same period. In 2005 roughly 25 percent of Venezuelan imports were consumer goods, 47 percent were intermediate goods, and the remainder capital goods for investment. About 30 percent of Venezuelan imports came from the United States.

¶4. (U) Comparing the twelve months through March 2006 with the preceding twelve, Venezuelan overall investment grew by a mere 0.5 percent. MetroEconomica reports that recent changes to the Venezuelan Central Bank's methodology for compiling the national accounts make it difficult to distinguish public-sector from private-sector investment in constant prices. But with overall investment growth of only 0.5 percent -- despite greatly increased BRV spending on roads, metro systems, hydroelectricity projects, and buildings and infrastructure for its social programs -- the consulting firm concludes that private-sector investment is at best constant, and perhaps falling.

¶5. (U) Longer term measures of these variables indicate that the recent figures in fact reflect trends under Chavez's watch. Overall consumption as a percent of GDP has increased from approximately 67 percent in 1999 to 78 percent in 2006.

Overall investment as a percent of GDP plummeted from roughly 34 percent in 2001 to 12 percent in 2003 (due to acute political uncertainty at the time), bounced back to 30 percent in the first quarter of 2005, but then fell again to roughly 25 percent in the first quarter of 2006. Moreover, the ratio of Venezuelan exports to imports AT CONSTANT 1997 PRICES has been falling (from 140 percent in 2003 to 80 percent in 2005) as the country's oil production, which accounts for roughly 80 percent of its exports, has stagnated while the volume of goods and services it imports has grown markedly.

¶6. (U) What do these figures mean in practical terms? Using both cash and credit the BRV and ordinary Venezuelans are purchasing increasing amounts of imported consumer goods. Automobiles and cellular phones are two leading examples. The Venezuelan Automotive Chamber reported that vehicle sales increased nearly 70 percent in 2005, compared to 2004, and a report by Venezuelan financial research firm Softline Consultores found that car loans increased by 229 percent over the same period. LG Electronics, a leading cellular phone and consumer electronics firm, recently reported that its Venezuelan sales have increased 700 percent since 2001. The Softline report further found that credit card purchases increased 73 percent in 2005. According to Venezuelan Central Bank data, overall bank credit for consumption has increased 360 percent from December 2003 to May 2006. Simply stated, Venezuelans are going shopping and incurring increasing amounts consumer debt.

IT'S YOUR POLICIES, STUPID

¶7. (U) Venezuelans' penchant for consuming instead of saving cannot simply be ascribed to cultural proclivities. BRV economic policies are fueling this consumer behavior, both directly and indirectly. Among the direct incentives are subsidies and price controls for goods of the basic food basket, health care services, and countless other consumer items. Such measures facilitate consumption not only of the

subsidized/price-controlled goods and services themselves, but, by freeing up additional income, also of automobiles, personal electronics, and the like. In addition, Chavez-decreed increases to the minimum wage over the past two years have far outpaced the rate of inflation, increasing the real purchasing power of low-income earners.

¶8. (U) In addition to these direct measures, there are at least three important policies indirectly driving consumer behavior: robust government spending, banking regulation, and the fixed foreign exchange rate regime. With the public coffers as well as its off-budget financial vehicles (e.g., the National Development Fund or "FONDEN") full of petrodollars, the BRV has increased public spending substantially: from the equivalent of USD 26 billion in 2003 to an estimated USD 42 billion for 2006. Moreover, these figures do not include BRV spending through its off-budget accounts, which analysts estimate could total another USD 10-15 billion this year. According to the Central Bank, M2 -- a monetary aggregate that includes currency in circulation, as well as demand, saving, and time deposits -- increased 57.5 percent, 50.4 percent, and 52.7 percent in 2003, 2004, and 2005, respectively. Despite the Central Bank's ongoing efforts to soak up excess liquidity (it sold roughly USD 1.6 billion in CDs to the banking sector from January to May of this year), M2 has increased more than 16 percent to date in 2006.

¶9. (U) This increased liquidity in turn has two primary effects. First, more money circulating in the economy

pursuing a slower growing quantity of available goods and services pushes up consumer prices, leading to inflation of 27.1 percent, 19.2 percent, and 14.4 percent in 2003, 2004, and 2005. While the BRV's stated aim is to reduce annual inflation to below 10 percent, most analysts forecast that it will hover around 12 percent for 2006. Second, as happens with any good, the greater supply of money in the economy lowers its price, here the "price" being the interest rates banks charge borrowers when they take out loans. Market interest rates have fallen steadily since 2003, squeezing banks' profitability. In response banks have increased their fees for various services, lowered their own borrowing costs -- that is, the interest they pay out to clients on savings accounts and time deposits -- and aggressively marketed higher risk credit to consumers, such as personal consumption loans and credit cards.

¶10. (U) Banks find their search for profitability hampered, however, by BRV-inspired regulation of the banking sector. Ostensibly, the Central Bank independently establishes interest rate regulations for banks, but few question the influence over the Bank's decision-making of Jorge Giordani, BRV Minister of Planning and Development, who sits on the board. Under Central Bank regulations issued in 2005, banks must pay out at least 6.5 percent on savings accounts and 10 percent on time deposits (e.g., CDs), and they may charge no more than 28 percent interest on loans and credits to borrowers. In addition, banks must allocate 31.5 percent of their loan portfolios among various classes of borrowers -- home buyers, farmers, small business owners, and the tourism industry -- all at preferential rates. Thus while banks' revenues and profits have been growing in absolute terms as they manage more market liquidity, their net financial margin per average asset, which measures profitability, has been narrowing: it shrank from 5.89 percent in December 2004 to 3.66 percent in December 2005.

¶11. (U) The net effect of the increased liquidity, inflation, falling interest rates, and banking regulations is that ordinary Venezuelans have far greater incentive to consume than to save and their banks have tremendous incentives to help them do so. Saving makes little financial sense for ordinary Venezuelans: with 14 percent inflation outpacing the 7 percent interest paid on savings accounts, would be savers

face a real interest rate of approximately negative 7 percent. Time deposits look little better, offering a real interest rate of around negative 4 percent, and banks anyway disfavor them because paying their regulation-mandated higher interest rates further squeezes profit margins.

¶12. (U) On the other hand, with interest rates on all forms of credit capped at 28 percent, ordinary Venezuelans face a maximum real interest rate on consumer and credit card debt of roughly 14 percent, favorable even by U.S. standards. Banks, moreover -- with approximately 46 percent of their asset portfolios in BRV bonds and Central Bank CDs paying them just over 10 percent, and another 31.5 percent of their assets in mandated lending at preferential rates -- have been aggressively and creatively marketing the remainder of their portfolios to higher-risk, higher-interest consumer credits. Beyond stepped up advertising, Venezuelan banks have been creating and promoting a wide array of consumer credit products: prizes for using credit cards; personal credit lines giving customers three times their monthly salaries and thirty-six months of financing for consumer purchases; and specialized personal credit lines for purchases of travel, cars, electrical appliances, furniture, televisions, video and sound equipment, computers, and cellular phones.

¶13. (U) BRV economic policy not only directly and indirectly encourages ordinary Venezuelans to consume instead of save,

it also encourages them to consume imports instead of local products. Here, the most culpable policy prescription is the fixed exchange rate. The BRV enacted exchange rate and currency controls in February 2003 to staunch widespread capital flight then taking place due to sharp political uncertainty. Since then it has kept the official exchange rate fixed, devaluing it periodically until it reached its current level of 2,150 Bolivars per USD (Bs/USD) in the first quarter of 2005. With the parallel market rate hovering around 2650 Bs/USD, most analysts estimate the Venezuelan currency to be overvalued by approximately 24 percent.

¶14. (SBU) Though the justification of severe capital flight perhaps no longer pertains, the BRV has maintained the fixed exchange rate policy, among other reasons, to help anchor inflation: by keeping the exchange rate fixed, the government artificially depresses the local prices of imported consumer, intermediate, and capital goods (tradables, in economic jargon). By way of example, if the government permitted the Bolivar to depreciate to its parallel market rate of approximately 2,650 Bs/USD, a USD 100 imported cellular phone now costing Bs 215,000 would instead cost Bs 265,000. Most analysts have been anticipating a devaluation of the Bolivar in 2007 after the December elections, but Rodrigo Cabeza, Chavista President of the National Assembly's Finance Committee, told EconCouns that the BRV would not devalue the currency next year (we shall see).

¶15. (U) Unless or until the BRV devalues the Bolivar, Chavez will be able to reap political gain for "keeping inflation in check," and ordinary Venezuelans will enjoy access to cheaper imports, incentivizing their consumption thereof. There are, however, important medium- and long-term negative consequences associated with the overvalued currency: it undermines the competitiveness of both Venezuela's non-oil export sector and its domestic, import-competing businesses. (NOTE: Because petroleum is sold on international markets in USD, the overvalued Bolivar does not affect oil exports. END NOTE.)

¶16. (U) Consider the following simplified example. Under the fixed exchange rate of 2,150 Bs/USD, a Venezuelan-produced manufactured good costing Bs 21,500,000 to make could be profitably sold overseas (eliminating transport costs, duties, etc., for present purposes) for any price over USD 10,000. If the Bolivar were depreciated to 2,650 Bs/USD, on the other hand, any would be buyer with US dollars could

obtain the same item instead for only USD 8,113.21. The overvalued Bolivar thus makes Venezuela's non-oil exports more expensive and less competitive. The flip side of this coin is that a Venezuelan consumer with 21,500,000 overvalued Bolivars can reach for a foreign-manufactured good (and the quality and cache associated with it) worth USD 10,000, instead of settling for a locally produced competitor. With the same 21,500,000 Bolivars depreciated to their parallel market value of 2,650 Bs/USD, the same Venezuelan would only be able to purchase foreign goods worth USD 8,113.21, making locally produced options more attractive.

¶17. (U) As a result of these incentives created by the overvalued fixed exchange rate, Venezuela's export-import ratio has been falling in real terms and its domestic private-sector manufacturers have suffered. The drop in the number of industrial firms doing business in Venezuela since Chavez came to power highlights these effects: CONINDUSTRIA, the Venezuelan industrial chamber, reports that roughly 11,000 manufacturers were open for business in 1999, while only 6,700 were operating in 2004.

¶18. (U) The phenomenon described above is known in economics literature as "Dutch Disease". Dutch Disease entails an

income boom to a single-commodity export economy appreciating its local currency, undermining the competitiveness of its export and import-competing sectors, reinforcing the economy's reliance on its primary export (here, oil) for foreign exchange, and leaving the country overexposed to a downturn in world prices for its export. (NOTE: The moniker comes from the travails of the Netherlands' manufacturing sector after natural gas deposits were discovered there in the 1960s. END NOTE.) Venezuela's oil endowment, elevated crude prices, the BRV economic policies detailed above and its general fostering of an uncertain business environment have generated symptoms of Dutch Disease in Venezuela. Facing a difficult and unpredictable climate, the private sector in general and small and medium businesses in particular are not investing in new production capacity. MetroEconomica, the macroeconomic consulting firm, estimates that investment would need to increase by 10 percent of GDP for Venezuela to maintain healthy economic growth: a development little likely given the current policy landscape.

WHAT HAPPENS WHEN THE MUSIC STOPS?

¶19. (SBU) COMMENT: Economic analysts are not as yet sounding alarms that Venezuela's economy faces grave short-term difficulties. Elevated petroleum prices foreseen for at least the next two to two and a half years will continue to cover a multitude of sins, enabling the BRV to reap short-term political gains by spending extravagantly, maintaining an overvalued Bolivar, and allowing -- indeed, encouraging -- ordinary Venezuelans to consume as if they were wealthier than they truly are.

¶20. (SBU) But history teaches that profligate government spending on large-scale infrastructure projects and populist subsidies and wage increases are politically difficult to restrain or cut back. Budgetary rigidities could thus overwhelm the Venezuelan oil sector's capacity to generate revenue, even in a climate of sustained high crude prices. During the price booms of the 1970s and early 1980s, Venezuela accumulated unmanageable levels of both domestic and foreign debt and experienced balance of payment difficulties even before oil prices began to fall. The eventual decline in oil prices made a difficult situation critical. It is thus possible, and even likely, that continuing on its current path Venezuela will experience macroeconomic and fiscal difficulties that render it unable to sustain the policies and public spending currently driving the consumption boom, even under a scenario of elevated oil

prices in the near and medium term.

¶21. (SBU) History also teaches, however, that those same high prices will bring new petroleum production online and encourage conservation, increasing supply and moderating demand. When (not if, but when) crude prices fall, or if the oil sector is unable to maintain current levels of production, Venezuela will find itself, as it did in the 1980s, with an anemic non-oil export sector, starved of adequate investment, and little able to earn the hard currency the country will need to maintain public spending and repay its hard-currency-denominated debts. As the flush of excess liquidity diminishes, market interest rates rise, and the BRV can no longer afford to defend the Bolivar's artificial strength, overly indebted Venezuelans will find themselves unable to afford their loan and credit card payments. Moreover, the imports they have been enjoying at bargain prices will no longer be as affordable, and the local economy will not have the productive capacity installed to meet domestic demand or create jobs. The ramifications for ordinary Venezuelans will be painful.

¶22. (SBU) Precisely how these events will unfold cannot be known for sure, but Venezuela's current course is not sustainable. One thing, however, is certain: if President Chavez is still in power when the music stops, the hardships then suffered by the Venezuelan people will no doubt, according to him, be the exclusive fault of the "The Empire". END COMMENT.

BROWNFIELD